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MCI

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OFFICE OF SECRETARY

July 12, 1995

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street, NW
Washington, DC 20554

DOCKET FILE COPY ORIGINAL

Re: CC Docket No. 94-1; Price Cap Performance Review for Local Exchange Carriers

Dear Mr. Caton:

Enclosed herewith for filing are the original and four (4) copies of MCI Telecommunications Corporation's Reply to Oppositions to its Petition for Reconsideration in the above-captioned proceeding.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Chris Frentrup

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Senior Regulatory Analyst
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Enclosure
CF

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20054

In the Matter of	)	
	)	
Price Cap Performance	)	
Review for Local	)	CC Docket No. 94-1
Exchange Carriers	)	

REPLY

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I. INTRODUCTION

Pursuant to Section 1.106 of the Commission's rules, MCI hereby submits its reply to oppositions to its petition for reconsideration of the Performance Review Order in the above-captioned docket.[1] In its petition for reconsideration, MCI argued that the key decisions made by the Commission in promulgating its "interim" plan were either not explained, not supported by record evidence, or were inconsistent with specific findings the Commission made in the Order.

II. PRODUCTIVITY FACTORS

MCI noted in its petition for reconsideration that selection of 4.0 percent as the minimum productivity factor, which was based on the Commission's studies of LEC productivity before price caps, was inconsistent with the Commission's finding that productivity had increased. The record on LEC productivity before price caps supported a productivity factor of 5.7 percent.

[1] In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, FCC 95-132, released April 7, 1995 (Performance Review Order).

MCI also noted that most of the LECs had chosen the highest (5.3 percent) productivity factor in the annual access filing implementing the Commission's decision in this docket.

Several of the local exchange carriers (LECs) claim that the fact that a great many LECs chose the 5.3 percent productivity factor reveals nothing about the LECs ability to achieve greater productivity levels than the current minimum embodied in the Commission's plan.[2] MCI submits that this selection is highly relevant. The LECs are now on record, in a situation where real money and not just regulatory posturing is on the line, that they can achieve, at a minimum, a 5.3 percent productivity. In fact, several of those LECs are also seeking waivers to allow them to make this election effective back to January 1, 1995, in effect raising their 5.3 percent productivity election by another 1 percent.

The LECs' claims that they cannot sustain this level in the long run[3] is also belied by the record in this proceeding. The Commission's own pre-price cap productivity study showed that the LECs as a whole achieved a productivity of 5.0 percent per year from 1984 through 1990.[4] The record in this proceeding shows that the LECs have achieved productivity of 5.7 percent per year since price caps began. As MCI has argued and as the LECs have now

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[2] See Sprint at 2; NYNEX at 4; GTE at 6; USTA at 2.

[3] See e.g., GTE 6-8; USTA at 4.

[4] See Performance Review Order at para. 206 and Appendix D.

demonstrated, the LECs can consistently achieve productivity well in excess of 5.0 percent.

Some LECs argue that MCI is incorrect in its claim that rates will rise to unreasonable levels with a productivity factor of 5.3 percent and no sharing, because rates will continue to fall with a productivity factor of 5.3 percent.[5] While it is true that near-term inflation is likely to be less than 5.3 percent and thus that rates will be minimally reduced in nominal terms, this will not guarantee that rates remain reasonable. As argued supra, the LECs were able to achieve productivity of 5.0 percent a year, even without the increased efficiencies brought forth by price caps. Thus, to allow the LECs to avoid sharing while giving them a too-low productivity factor, as the Commission has done, will ensure that the benefits of price caps inure only to LEC shareholders, not to ratepayers.

The 4.0 percent minimum productivity factor the Commission chose was far too low and inconsistent with its determination that productivity had increased under price caps. Based on the record in this proceeding, the Commission on reconsideration should raise the productivity factor to at least 5.7 percent.

III. SHARING / LOW END ADJUSTMENTS

The LECs make several arguments regarding sharing. First, they argue that it was reasonable for the Commission to adopt a no sharing/low end

[5] See Rochester at 3; NYNEX at 11.

adjustment productivity option with the productivity factor set at 5.3 percent.[6] The LECs claim that the Commission justified the no sharing option by noting that any sharing obligation blunts the efficiency incentives a price cap plan is intended to call forth. However, none of these LECs addressed MCI's point; the Commission has not justified its choice of 5.3 percent as the productivity factor at which the sharing obligation can be eliminated. If the productivity factor is properly set, MCI agrees that there can be a no-sharing option. However, the Commission has not explained the basis on which it concluded that a productivity factor of 5.3 percent protects ratepayers. As discussed supra, MCI has shown that the 5.3 percent productivity factor is at the lower end of the range of reasonable productivity factors. Thus, setting a productivity factor at 5.3 percent with no sharing obligation cannot be viewed as adequately protecting ratepayers from unreasonably high access charges.

Second, the LECs argue that Section 201 of the Communications Act does not require limitations on LEC earnings, only on their rates.[7] These comments miss MCI's point. MCI's view is that Section 201 compels the Commission to ensure that rates are not unreasonable. Because the Commission does not permit customers to file complaints based on a price cap LECs' earnings levels,[8] and because there is no performance review required

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[6] See Sprint at 4; Rochester at 2; NYNEX at 10.

[7] See Rochester at 4; NYNEX at 10-11; GTE at 16-17; BellSouth at 8; USTA at 13-14.

[8] Performance Review Order at para. 224.

in this allegedly "interim" plan, a LEC electing 5.3% can generate higher productivity gains and reap a windfall from the new price cap plan at ratepayers' expense, with no possibility of correction. It follows that any LEC earning this windfall profit must be charging some rates that are unreasonably high. However, access ratepayers have no recourse for obtaining relief from these unreasonable rates.

Third, the LECs argue that the low end adjustment mechanism is not redundant, as MCI had claimed, and must be maintained.[9] The possibility of above-cap filings and price cap waivers would be administratively burdensome, the LECs claim, and thus cannot substitute for the low end adjustment mechanism. MCI argues that the low end adjustment mechanism is unnecessary because the LECs can already make above-cap filings or seek a waiver of the price cap rules. The low end adjustment allows the LECs to take one-time charges in one tariff year, thereby depressing their earnings and possibly taking a low end adjustment for that year, and then retaining potentially all or half of the productivity improvements that occur because of that write off. MCI urges the Commission to eliminate the low end adjustment mechanism for this reason.

Finally, the LECs argue that no adjustment to the sharing bands is necessary, because the LECs cost of capital has not changed.[10] They argue

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[9] NYNEX at 12; GTE at 18-19; USTA at 17.

[10] USTA at 7-8.

that the cost of capital has not changed since the Commission set it in 1991, that any changes in the LECs' cost of debt were due to shareholder-funded refinancing activity, and that the cost of capital is reflected in the GNP-PI, just like any other input cost.[11]

MCI believes the LECs cost of capital has changed since 1991. The LECs' cost of equity has remained relatively fixed, but their cost of debt has fallen. In addition, the relative mix of debt and equity has shifted in favor of lower cost debt. Even if these events had not occurred, the Commission should reconsider whether the LECs' authorized rate of return still needs to include the premiums it did when the Commission originally set the rate of return at 11.25 percent. MCI has argued that these changes justify a re-adjustment of the sharing bands, and of the LECs' rates. The LECs have had the protection in their rates for four years, through a sharing mechanism which was set at too high a level. The Commission should on reconsideration reset both the LECs' rates and the sharing bands to reflect the current cost of capital.

IV. EXOGENOUS CHANGES

The LECs oppose MCI's proposal that exogenous changes be limited to only those cases in which money is moved into or out of the interstate jurisdiction, because they believe they may be other costs outside the control of the LEC which would not be reflected in the Price Cap Index (PCI), or

[11] See GTE at 14-15; BellSouth at 9-10.

because this standard would not apply to the exogenous changes already in the Commission's list of exogenous changes, such as Reserve Deficiency or Inside Wire Amortizations (RDA or ISW).[12] While it is unclear what kind of costs the LECs believe would not be otherwise reflected in the PCI, it would seem that managing unexpected changes in costs is precisely the kind of action that a competitive industry must make. Thus the Commission can adopt MCI's proposal and provide LECs with those incentives. In addition, although both RDA and ISW are complete, MCI's proposal would encompass these kinds of changes and any other similar amortizations in the future.

The LECs also oppose MCI's request for exogenous treatment for changes in the subsidy payments from the Universal Service Fund and triple-DEM weighting when a price cap company sells an exchange to a non-price cap company.[13] Such treatment is unnecessary, the LECs claim because there is already an exogenous adjustment for the effect on the revenue requirement of the sale of the exchange, or because there may be no change to the subsidy payments. In addition, the LECs note that the courts have rejected the kind of automatic flow through of capital gains to ratepayers that MCI advocates.[14]

These arguments are not to the point. The effect for which MCI seeks exogenous treatment is above and beyond the revenue requirement change for

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[12] See Rochester at 6-7; NYNEX at 18.

[13] Rochester at 7, n. 19; GTE at 24-26; USTA at 24.

[14] GTE at 25; USTA at 25-26.

which the Commission has granted exogenous treatment. In cases where there is no subsidy change, of course there would be no exogenous change. However, MCI does not believe that this would always be the case, and asks the Commission on reconsideration to require the LECs to make a showing that there is no such effect, or to adjust their PCIs to reflect it. Finally, the LECs claim that the court's ruling in *Democratic Central Committee* prohibits automatic return to ratepayers of any capital gains.[15] In fact, in that case the court rejected automatic retention of capital gains by the utility, ruling that the capital gains must go to the party that paid for the asset and bore the risk of its change in value. The access customer, by paying for the subsidy, has borne the burden of paying for the asset that resulted in any premium realized by the LEC, and insured the LEC against risk. Under the case cited by the LECs, the access customer should be the one who receives the reward of that premium.

V. ADDITIONAL DOWNWARD PRICING FLEXIBILITY

The LECs maintain that MCI's concerns about the additional downward pricing flexibility that the Commission granted are unfounded, because the LECs' upward pricing flexibility remained unchanged. The LECs claim that there is thus no additional ability for them to use this downward flexibility for one group of customers to further raise rates to a different group of customers. This argument is incorrect. If the LECs lower some rates by the full 10 percent

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[15] Democratic Central Committee of the District of Columbia v. Washington Metropolitan Area Transit Commission 485 F. 2d 786 (D.C. Dir. 1973) cert. denied 415 U.S. 935 (1974).

allowed by the Commission's additional flexibility, this will increase the amount by which they can raise other rates, while still remaining within the overall upper limitation for these rates. Additional downward flexibility does give the LECs more freedom to raise other rates. MCI urges the Commission to reconsider the expanded limits it granted the LECs.

VI. CONCLUSION

The LECs, their ratepayers, and the economy will maximize the benefits from price caps only if the plan is properly designed. For the foregoing reasons, MCI urges the Commission to reject the LECs' arguments, and reconsider its decisions concerning the aspects of its price cap decision discussed in MCI's petition for reconsideration.

Respectfully submitted,
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July 12, 1995

STATEMENT OF VERIFICATION

I have read the foregoing and, to the best of my knowledge, information, and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on July 12, 1995.

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CERTIFICATE OF SERVICE

I, Stan Miller, do hereby certify that copies of the foregoing Reply to Opposition to its Petition for Reconsideration were sent via first class mail, postage paid, to the following on this 12th day of July, 1995.

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